DESCRIPTION OF

H.R. 1296

AND OTHER TAX MATTERS

RAISED BY THE

PAYMENT-IN-KIND (PIK) PROGRAM

Scheduled for A Hearing

on February 23, 1983

Before the

Subcommittee on Select Revenue Measures

of the

Committee on Ways and Means

Prepared by the Staff

of the

Joint Committee on Taxation

February 22, 1983

JCX-3-83

J862-39
H782-25

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the Committee on Ways and Means has scheduled a hearing, to be held on February 23, 1983, on H.R. 1296 (introduced by Mr. Harkin and others) and other tax matters raised by the agricultural commodities payment-in-kind (PIK) program.

The first part of this document is a summary of H.R. 1296 and other tax matters raised by the PIK program. The second part is a description of the PIK program. The third part is a description of present law relating to the matters addressed by H.R. 1296. The fourth part is a description of the issues relating to the matters addressed by H.R. 1296. The fifth part is a description of H.R. 1296, including revenue effects. The sixth part is a description of present law and the issues relating to other tax matters raised by the PIK program which are not addressed by H.R. 1296.

I. SUMMARY

The Administration (Department of Agriculture) has adopted a payment-in-kind (PIK) program under which farmers are paid with commodities for diverting all or certain portions of their farmland from production.

H.R. 1296 would permit farmers to elect to defer recognition of income (commodities) actually or constructively received under the PIK program until the commodities are sold. In addition, the bill would provide that participation in the PIK program would not prevent land diverted from production under the PIK program from qualifying for the special estate tax rules which permit current use valuation of real property used for farming purposes.

A number of tax matters are raised by the PIK program other than the matters addressed by H.R. 1296. These include--

(1) the time for payment of tax attributable to income from the PIK program;

(2) whether certain corporations which participate in the PIK program are engaged in the business of farming and, therefore, must use the accrual method of accounting;

(3) whether land withdrawn from production under the PIK program is land used in farming, and whether income from participation in the PIK program is gross income from farming for purposes of the rules permitting expensing of soil and water conservation expenses;

(4) whether land diverted under the PIK program is land used for farming for purposes of the rules which permit the expensing of fertilization expenses;

(5) whether income from participation in the PIK program is income from farming for purposes of the rules permitting expensing of the costs of clearing farm land;

(6) whether the ownership of property diverted under the PIK program is an activity not engaged in for profit for purposes of the rules which limit the deductibility of excess expenses from activities not engaged in for profit;

(7) the tax treatment of cooperatives which market commodities received under the PIK program and their members or patrons;

(8) whether income derived by a corporation from participation in the PIK program is passive income for purposes of that corporation qualifying as a subchapter S corporation;

(9) whether income derived from participation in the PIK program is subject to the tax on self-employment income;

(10) whether land diverted under the PIK program is eligible for the special provisions permitting installment payment of estate tax attributable to property used in certain closely held trades or businesses.

II. DESCRIPTION OF THE PAYMENT-IN-KIND ("PIK") PROGRAM

Overview

The Department of Agriculture's payment-in-kind ("PIK") program is a program for diverting from production land which otherwise would be used to produce crops of wheat, corn, sorghum, rice, and upland cotton. Under the program, producers will be provided a quantity of a commodity as compensation for diverting acreage normally planted in that commodity. As presently announced, the PIK program applies only for the 1983 acreage reduction program.

The PIK program is in addition to the previously established acreage reduction and price support programs available to farmers. The previous programs provide for cash, rather than in-kind, payments. Farmers must be participants in these cash payment programs as a condition of eligibility for the PIK program.

PIK Program

General rules.--Under the PIK program, farm producers generally may elect to divert from 10 to 30 percent of their crop acreage base[1] from active crop production in exchange for a payment-in-kind equal to an established quantity of the commodity normally grown on the property. The established percentage is the farm's program yield[2] times 95 percent for wheat and 80 percent for corn, grain, sorghum, upland cotton, and rice multiplied by the PIK acreage.

In lieu of the guaranteed 10 to 30 percent PIK diversion election, farmers may elect to divert the whole crop acreage base (other than property in the cash diversion program) for the farm on a bid basis. If a whole crop bid is made, the farmer offers to reduce his or her planted acreage of the crop to zero. As part of his or her bid, the farmer specifies the percent of the farm's program yield that he or she will accept as compensation. The lowest bids will be accepted first. If the whole base bid is accepted, the bid compensation rate applies to the entire PIK acreage. If the

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[1] The term crop acreage base means the acreage devoted to production of the crop involved during a base period. The crop base is presently established under the Omnibus Reconciliation Act of 1982.

[2] The term farm program yield means the yield of the crop covered by a PIK contract on the farm property during an established historical reference period.

whole base bid is not accepted, the farmer is still entitled to PIK diversion of 10 to 30 percent of his or her crop acreage base at the established compensation rate for the crop involved.

Whether whole base PIK bids will be accepted depends on the amount of property for which PIK elections are made in the county where the property is located. The total acreage withdrawn from production of a crop under all Federal government land diversion programs cannot exceed 50 percent of the total acreage base for the crop in any county. All 10 to 30 percent elections will be accepted before any whole base bids are accepted.

If a farmer has a crop base in more than one crop included in the PIK program, he or she may elect to utilize the program for any combination or all of the crops. The total crop base diverted cannot, however, exceed the total acreage comprising the farm.

Property withdrawn from crop production under the PIK program must be devoted to conservation uses. Generally, this will result in the property being planted with a cover crop to prevent erosion and otherwise being permitted to lie fallow. The PIK acreage may be grazed other than during the six principal growing months of the PIK crop. Harvesting of any crop from land diverted under the PIK program generally will be prohibited.

Applications for both the guaranteed percentage PIK program and the whole base bid program must be submitted by March 11, 1983. All 1983 contracts must be signed by March 17, 1983. Whole base bids will be accepted or rejected at public county meetings on March 18, 1983. Executed PIK contracts are transferable by the farmer under certain circumstances; however, failure to comply with the contract terms can result in forfeiture of payments and, in certain cases, in liquidated damages.

Payment procedures.--Participating farmers will be eligible for payment-in-kind on a date established for their locality. The payment dates range from June 1 for wheat in certain Southern areas to November 1 for corn in certain Northern States. The payment availability dates reflect the usual harvest dates of PIK crops in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

The PIK commodities will be paid from surplus commodities held by the Federal Government. The Federal Government acquires these commodities through loan

cancellations in the crop loan and price support programs administered by the Commodity Credit Corporation ("CCC")[3] and the Farmer-owned Reserve ("FOR").[4] The CCC and FOR programs are similar, except CCC loans are normally made for a 9-month period while FOR stocks generally are held off the market for 3 years. In the case of payment from farm-stored FOR stocks, farmers will be paid an additional 7 months of storage costs beyond the normal 5 months allowed under the PIK program.

The method of payment under the PIK program will vary, depending on whether the farmer has outstanding loans with the CCC or has grain in the FOR. If the farmer has no commodities pledged under these programs, he or she will receive payment from government stocks of the commodity involved. If the farmer has commodities pledged under either of the programs, the payment will take the form of a 3-step transaction. First, the farmer will repay an amount of his outstanding loans equal to the PIK payment[5]. At that time, a pro rata portion of the loan security will be released. Second, the Government will repurchase the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and storage charges paid by the farmer on repayment of the loan). Finally, the Government will return the commodities to the farmer as a payment-in-kind under the PIK contract.

Special procedures for upland cotton and rice.--PIK payments of upland cotton and rice generally will be made by the Government to a farmer's cooperative. If an upland cotton or rice producer markets his or her crop through a

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[3] The CCC is a Federally-owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

[4] A portion of the commodities will be acquired through transactions, the substance of which is loan cancellation, with farmers who have such loans outstanding immediately before they receive payments of commodities under the PIK program.

[5] Except in the case of upland cotton, the farmer can choose which loans to repay. Cotton loans must be repaid in the order in which the crops under loan were produced.

cooperative, the cooperative will receive the payment otherwise due the farmer under the PIK contract. Other farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives will be the same as for individual farmers dealing directly with the Government. PIK payments to cooperatives will be held in pools separate from other crops held by the cooperatives.

Cash Payment Acreage Reduction Program

As stated in the Overview, farmers must participate in the cash payment acreage reduction program as a prerequisite of eligibility for the PIK program. This cash diversion program consists of two facets. First, the farmer must divert from production an established percentage of his or her acreage base in exchange for diversion payments.[6] This required percentage varies with the crop--wheat, feed grains, corn, rice, and upland cotton. The payment is a statutorily prescribed amount per crop unit times the farm program payment yield for each acre diverted.

Second, the farmer must divert from production an additional percentage of his or her otherwise planted crop acreage for no pay. As with the so-called paid diversion, this no pay percentage varies with the crop involved (e.g., 12-1/2 percent for corn at the present time). These two diversion requirements generally result in approximately 20 percent of the farmer's crop acreage base being withdrawn from production in addition to any land so withdrawn under the PIK program. As with acreage in the PIK program, property withdrawn under the cash payment program must be devoted to conservation use.

Participation in the cash payment program also entitles the farmer to deficiency (price-support) payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price.

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[6] The Omnibus Reconciliation Act of 1982 authorized advance payment of prescribed percentages of payments for 1982 and 1983 crops (normally made in 1983 and 1984) during 1982. Additional advance payments of 1983 crops (normally made in 1984) are permitted in 1983. Advance payments are made at the option of the farmer.

III. PRESENT LAW

A. Income Tax Treatment of Farmers--Timing of Income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than $1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

Under the cash method of accounting, income is recognized for the year in which it is actually or constructively received. Income is constructively received by a taxpayer when it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time (Treas. Reg. sec. 1.451-2(a)). A taxpayer who uses the cash method of accounting must recognize income when he is entitled to receive commodities under a payment-in-kind program.

Under the accrual method of accounting, income is generally recognized when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when received (Treas. Reg. sec. 1.451). A taxpayer who uses the accrual method of accounting must recognize income when he has the right to receive commodities under a payment-in-kind program, regardless of the time of actual receipt.

Thus, under both the cash and accrual methods of accounting, the taxpayer will recognize income when the commodities are made available to the farmer. In addition, under both methods, when property rather than cash is received, the amount to be included in income is the fair market value of the property on the date the taxpayer recognizes the income.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding the income from discharge of indebtedness (Code sec. 108) but with a corresponding reduction in the basis of certain assets (Code sec. 1017).

A farmer, who has commodities pledged for outstanding loans under the CCC or FOR programs, generally will receive his or her pledged commodity as a payment-in-kind under the

PIK contract with a corresponding reduction in the amount of the CCC or FOR loan. However, as indicated in the discussion of the PIK program, this result will be achieved through a three-step process under which the loans are first repaid, followed by a purchase by the Federal Government of the commodity, and then a payment-in-kind of that commodity. It is unclear, under present law, whether such series of transactions will be treated as discharge of indebtedness or will follow the form of the transaction and be treated as a repayment of the loan by the farmer, a sale of the commodity to the CCC, and a return of the commodity to the farmer as a payment-in-kind.

B. Estate Tax Treatment of Farmers--Current Use Valuation of Certain Farm Real Property

Qualification of Decedent's Estate

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, real property used in family farm operations and other closely held businesses may be included in a decedent's estate at its current use value, rather than its full fair market value. The maximum reduction in value permitted under the current use valuation provision is $750,000 per estate (Code sec. 2032A).

One of the requirements for specially valuing property is that minimum percentages of the decedent's estate must consist of real property which, among other attributes, has been used in a "qualified use" during certain specified periods. First, at least 50 percent of the adjusted value[7] of the decedent's estate must consist of the adjusted value of real and personal property used in a qualified use on the date of the decedent's death. Second, at least 25 percent of the adjusted value of the decedent's estate must consist of real property used in a qualified use. Third, all real property to be specially valued must have been used in a qualified use both on the date of the decedent's death and for periods aggregating at least 5 years of the 8-year period ending on the date of death.

Another requirement is that the decedent or a member of his or her family must materially participate in the farming operation in which the real property to be specially valued is used. Material participation must occur during periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death. A special rule for individuals who are retired or disabled on the date of their deaths permits the material participation requirement to be satisfied by disregarding periods after the individuals began receiving social security benefits or became disabled, if the retirement or disability was continuous until the date of death.

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[7] The adjusted value of a decedent's estate is equal to the gross value of the estate minus indebtedness payment of which is secured by property in the estate. Similarly, the adjusted value of an asset is equal to the gross value of the asset minus indebtedness payment of which is secured by the asset.

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Recapture of Tax Savings in Certain Circumstances

If, within 10 years[8] after the death of the decedent (and before the death of the heir receiving the property), specially valued property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purpose based upon which it was valued in the decedent's estate (i.e., its "qualified use"), all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" or "recapture tax." During the recapture period, the qualified use requirement must be satisfied at all times.[9]

The recapture tax is imposed on the qualified heir rather than the decedent's estate. However, the tax liability is measured by reference to the estate tax saved by the decedent's estate. In the case of a partial cessation of qualified use, the recapture tax is prorated based upon the percentage of the specially valued property that is no longer used in the qualified use.

Material participation in the farm operation is also required during the recapture period. Except in the case of "eligible qualified heirs,"[10] the heir receiving the property or a member of the heir's family must materially participate in the farm operation for periods aggregating at least 5 years of every 8-year period ending after the date of the decedent's death and before expiration of the recapture period. Failure to satisfy the material participation requirement during the recapture period is deemed to be a cessation of qualified use.

Definition of Qualified Use

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[8] The recapture period is 15 years in the case of estates of decedents who died before 1982.

[9] A special rule disregards a period beginning on the decedent's date of death and ending not more than 2 years later; however, the recapture period is extended by a period equal to any part of this 2-year period when the qualified use requirement is not satisfied.

[10] An eligible qualified heir can satisfy the material participation requirement through "active management," a lesser standard of personal involvement than material participation. Eligible qualified heirs include surviving spouses, minors, full-time students, and disabled individuals.

The term qualified use has the same meaning under both the pre-death requirement and the recapture period requirement. In general, a qualified use is a use in farming or in another closely held business. The business in which specially valued real property is used must be an active operation, as opposed to a passive investment activity. In the case of farms, the activity requirement is normally satisfied by the production of crops or raising of animals for profit.[11]

Additionally, the decedent or a family member (during pre-death periods) and each qualified heir owning a present interest in the property (during the recapture period) must own an equity interest (i.e., be at risk) in the business operation. The element of risk must be as to both price and production. Thus, for example, the qualified use requirement is not satisfied during any periods when the party who is to satisfy the qualified use requirement withdraws the property from productive use[12] or leases the property pursuant to a net cash or other fixed return lease.

Because real property is withdrawn from crop production under the payment-in-kind ("PIK") program in exchange for a fixed payment, such real property may not be considered to be used in a qualified use.

Definition of Material Participation

Material participation means personal involvement in an active farming operation to a material degree. The determination of whether this requirement is satisfied is factual and is based on factors such as participation in making business decisions, inspection of crops, and other farm activities in which the participant engages.

Material participation for purposes of the current use valuation provision is defined by reference to the meaning of the same term as used in the social security tax provisions. Therefore, the participant's activity must be sufficient to convert his or her income from "passive rentals" to "earned income" for purposes of the self-employment income (SECA) tax. As earned income, the farm income is subject to the

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[11] A so-called "hobby farm" which is an activity not engaged in for profit under section 183 does not satisfy the qualified use requirement (Treas. Reg. sec. 20.2032A-3(b)(1)).

[12] Property permitted to lie fallow during nonproducing seasons or as part of a regular crop rotation program is treated as satisfying the requirement during these temporary periods.

SECA tax. In addition, for certain persons under age 70, social security benefits may in some cases be reduced if this income exceeds prescribed amounts.

It is unclear under present law whether management of land withdrawn from production under the PIK program is used in a farming operation involving sufficient personal involvement to constitute material participation.

IV. ISSUES PRESENTED BY H.R. 1296

Income Tax Treatment of Farmers--Timing of Income

The first issue posed by the bill is whether a farmer should recognize income from participation in the PIK program at the time he or she is entitled to receive the commodity, at the time he or she actually receives the commodity, or at the time he or she disposes of the commodity.

Estate Tax Treatment of Farmers--Current Use Valuation

The second issue posed by the bill is whether the requirement that all specially valued real property be put to productive use in an active business operation in which the decedent or a member of his or her family (during pre-death periods) or the qualified heir (during the recapture period) is at risk should be modified to permit property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government to qualify for current use valuation.

The third issue posed by the bill is whether the current use valuation material participation requirement should be modified to provide that material participation is present with respect to farm real property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government.

V. DESCRIPTION OF H.R. 1296

A. Income Tax Treatment of Farmers--Timing of Income

The bill would provide an election for a taxpayer who would otherwise be required to recognize income under present law on receipt of any agricultural commodity under a Federal farmland removal program to treat the commodity as if it were produced by the taxpayer. If the taxpayer elects this treatment, both accrual basis and cash basis taxpayers would report income when the commodity is sold. If a taxpayer elects this treatment, the taxpayer's basis in the commodity would be zero.

The bill would provide an election for a taxpayer who would otherwise be required to recognize income by reason of the cancellation of a qualified support loan. The taxpayer could elect to recognize income in the year the commodity which secures the loan is disposed of (or consumed). The amount to be included in income in a year would bear the same ratio to total income from the cancellation of the loan as the amount of the commodity sold in such year bears to the total amount of the commodity which secured the loan.

These elections could be made separately with respect to each receipt of a commodity and each loan cancelled.

B. Estate Tax Treatment of Farmers--Current Use Valuation of Certain Farm Real Property

H.R. 1296 would provide that the pre-death, date of death, and recapture period qualified use requirements of the current use valuation provision are deemed to be satisfied during periods when real property otherwise eligible for current use valuation is withdrawn from production in exchange for a fixed payment under a Federal farmland removal program.

The amendment to the pre-death and date of death requirements would apply to estates of individuals dying after December 31, 1982. The amendment to the recapture period requirement would apply to property withdrawn from production under a Federal farmland removal program after December 31, 1982.

C. Revenue Effect

Without modifications to present law, taxpayers who divert land from production under the PIK program would incur

different tax consequences than if they used the land for production. These consequences generally would increase tax liabilities and accelerate tax collections. The present estimates of budget receipts contained in the budget resolution for fiscal year 1983 do not reflect these increased tax receipts resulting from the PIK program. The adoption of H.R. 1296 or other relief rules generally would offset these additional receipts that arise by the adoption of the PIK program. Thus, the enactment of H.R. 1296 would leave budget receipts essentially at the level contemplated in the budget resolution. Under these circumstances, it may not be appropriate to account for H.R. 1296 as a revenue-reducing bill.

Revenue increases arising from decreased outlays as a result of the PIK program offset the revenue loss from H.R. 1296. H.R. 1296 is estimated to affect fiscal year budget receipts by the following amounts:

	1984	1985	1986
	(millions of dollars)		
One-year PIK:			
Income tax	-476	+476	
Estate tax	-615	--	
	-1,091	+476	
Two-year PIK:			
Income tax	-476	-120	+596
Estate tax	-615	-296	--
	-1,091	-416	+596

VI. TAX ISSUES RAISED BY THE PIK PROGRAM NOT ADDRESSED BY H.R. 1296

A. Income Tax Treatment of Farmers

1. Time for payment of tax

Present law

In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax would be considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (Code secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates would apply to taxable years beginning on a date other than January 1st. However, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66-2/3 percent of the tax liability for the year (Code sec. 6654(d)).

Issues

The first issue is whether income from the sale of commodities received in the PIK program would qualify as gross income from farming for purposes of the estimated tax payment provisions and, if so, when the income is recognized.

The second issue is whether income from the assignment of a PIK contract should be treated as gross income from farming, whether it should be ordinary income and, when the income is recognized.

2. Method of accounting for corporations engaged in farming

Present law

Generally, taxpayers engaged in farming may determine their incomes for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations, and certain corporations with annual gross receipts of less than $1 million) and certain partnerships that are engaged in the trade or business of farming are required to be on the accrual method (Code sec. 447).

Issue

The issue is whether a corporation or other person described in section 447 is required to use the accrual method of accounting because the corporation is engaged in the trade or business of farming by reason of its participation in the PIK program.

3. Soil and water conservation expenditures

Present law

Under present law, a taxpayer engaged in the business of farming may expense amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming, but not in excess of 25 percent of the gross income derived from farming during the taxable year (Code sec. 175). Any amount not deductible in any taxable year because of the 25 percent of gross income limitation may be deducted in succeeding taxable years in the order of time so long as any taxable year's deductions under this provision do not exceed 25 percent of gross income from farming for that taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Under present law, if a taxpayer disposes of farm land which he or she has held for fewer than 10 years, a certain proportion of the gain realized on the disposition is treated as ordinary income (Code sec. 1252). That proportion is the lower of a percentage of the aggregate deductions allowed under sections 175 and 182 for expenditures made with respect to the farm land after 1969, or the excess of the amount

realized (or the fair market value) over the adjusted basis of such land. For this purpose, the term "farm land" is land with respect to which deductions have been allowed under sections 175 or 182.

Issue

The first issue is whether land withdrawn from production under the PIK program is land which would qualify as land used in farming within the meaning of section 175. The second issue is whether income earned from PIK payments is income derived from farming during the taxable year which would increase the 25 percent limitation, and, if so, when the income is recognized.

4. Expenditures by farmers for fertilizer, etc.

Present law

Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (Code sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production crops, fruits, or other agricultural products, or for the sustenance of livestock.

Issue

The issue is whether land withdrawn from production under the PIK program will still qualify as land used in farming for purposes of this provision.

5. Expenditures by farmers for clearing land

Present law

Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (Code sec. 182). However, this deduction for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined). Such expenditures are subject to recapture under section 1252 (see item 3, above).

Issue

The issue is whether income derived from participation in

the PIK program is income derived from farming for the purpose of this provision and, if so, when the income is recognized.

6. Activities not engaged in for profit

Present law

Under present law, if an individual or a Subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (Code sec. 183).

Issue

The issue is whether income received under the PIK program constitutes income from an activity engaged in for profit so that additional expenses attributable to that activity (e.g., the farm) may be deducted and, if so, when the income is recognized.

7. Gain from disposition of property used in farming or farm losses offsetting farm income

Present law

Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deductions which do not result in a tax deduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

The purpose of section 1251 is to prevent persons from taking ordinary loss deductions with respect to pre-1976 taxable years and then selling the farm property at capital gains rates.

Issue

The issue is whether income derived by a farmer under the PIK program should be viewed as gross income from farming for purposes of section 1251 and, if so, when the income is recognized.

8. Qualification of corporations for Subchapter S status

Present law

Under present law, certain closely held corporations can elect a special tax status (Code secs. 1371-1375). These subchapter S corporations are not taxed on income at the corporate level. Rather, their income is taxed to the shareholders, regardless of whether or not it is actually distributed during the year.

One requirement for electing subchapter S status for corporations which had accumulated earnings and profits while it was not a subchapter S corporation is that during the last three taxable years prior to the election no more than 25 percent of the gross receipts of the electing corporation be passive investment income. Passive investment income is defined to include gross receipts received from rents.

Issue

The issue is whether payments-in-kind under the PIK program are passive income within the meaning of the limitation on such income for subchapter S corporations.

9. Self-employment income

A self-employment tax is imposed on net earnings from self-employment as defined by section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agricultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity. Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income.

Issue

The issue is whether income derived from participation in the PIK program is self-employment income.

B. Tax Treatment of Cooperatives

Present law

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a non-qualified written notice of allocation. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates. Patronage dividends (whether paid in cash, in qualified written notices of allocation, or in redemption of nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.[13] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income and income derived from the sale or exchange of capital assets, is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not

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[13] A patronage dividend must be payable (1) on the basis of quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of 8 percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

Issue

The issue is whether income derived by a cooperative from the disposition of commodities received under the PIK program or from the closing of loans pursuant to the PIK program should be treated as patronage source income for purposes of determining whether the cooperative may qualify as an exempt cooperative and whether a nonexempt cooperative is allowed a deduction for distribution of income from PIK payments.

C. Estate Tax Treatment of Farmers--Installment Payment of Estate Tax

Present law

Overview.--In general, estate tax must be paid within 9 months after a decedent's death. However, if at least 35 percent of the value of the decedent's adjusted gross estate is comprised of the value of an interest in the closely held business and if certain other requirements are satisfied, payment of estate tax attributable to the interest in the closely held business may be extended and paid in installments during up to 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest). The determination of whether the decedent owns an interest in a closely held business is made as of the decedent's date of death (Code sec. 6166).

A special 4-percent interest rate is provided for estate tax attributable to the first $1 million in value of the closely held business interest (Code sec. 6601(j)). Tax in excess of this amount ($345,000 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (Code sec. 6601(a)). The regular deficiency rate currently is 16 percent.

Under present law, proprietorships owned by the decedent may qualify as an interest in a closely held business. In addition, an interest in a closely held business may include interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied.

Definition of trade or business.--Only interests in active trades or businesses, as contrasted to passive investment assets, are eligible for the intallment payment provision. The determination of whether an interest in an active trade or business is present is factual and must be made on a case-by-case basis.

In Revenue Ruling 75-366, 1975-2 C.B. 472, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The Internal Revenue Service ruled that the decedent was in the business of farming under these facts stating:

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case, the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.
>
> Accordingly, the farm real estate included in the decedent's estate qualifies...as an interest in a closely held business. (Id.)

Issue

The issue is whether property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government should qualify for the special rule permitting deferral and payment in installments of estate tax attributable to an interest in an active trade or business.